CHAPTER 19 - Economic Policy

OVERVIEW

Presidential popularity is significantly influenced by national economic conditions. The result is that presidents give economic issues top priority. One independent agency that assists in this regard is the Federal Reserve Board. Relying on fiscal policy has declined.

Growth of the public debt has been accelerated by the indexation of taxes and benefits. The end of indexation marked a new era of Congress having to take blame for economic problems. One result was increasing attention to ways of reforming the tax system. The debate is often over the progressivity of taxes and their visibility.

In spite of Americans' dislike for the tax system and economic problems, when compared with Western European countries, they do not appear that bad.

OUTLINE

I. Governments and Markets

- In large complex societies, even self-interested citizens need government protection if they are to engage in the simplest of economic transactions. The role of government in the economy has become more expansive (and politically controversial) over time, as we shall see. But it is important to point out that, at a basic level, government institutions provide the stability and certainty that make prosperous economies possible.

II. Economic Growth and the Business Cycle

- Economies grow as a result of technological innovations, investments in physical capital, and investments in human capital.
- Short-term fluctuations in the economy such as recessions and recovery are referred to as the business cycle.
- Governments try to offset the problems associated with the business cycle: inflation and unemployment.

III. Economic Conditions and Political Fortunes

- When economic times are hard, people tend to blame those in charge. The popularity of the president drops during recessions. Terrible economic times in American history are associated with massive election losses for the party of the president. Prosperity, however, strengthens a president's position for reelection.
- Carter found himself in the worst position when running for reelection. Unemployment and inflation were both simultaneously high thus leading to stagflation.
- While it does not guarantee popularity, prosperity generally strengthens a president's position and has an effect on other federal, state, and even local elections.

IV. Fiscal Policy

- Fiscal policy consists of government spending and taxing decisions. If government expenditures exceed revenues, government runs a deficit. If government revenues exceed expenditures, government enjoys a surplus.

A. The Use of the Budget Deficit

- One important economist in the 1920s, John Maynard Keynes (his economic philosophy is called Keynesianism), argued that not all deficit spending was bad. President Franklin Roosevelt was influenced by Keynes' philosophy.
- In 1946, Congress created the Council of Economic Advisers (CEA) to advise the President.

B. Decline of Fiscal Policy

1. Divided Government

- In order for fiscal policy to work as a solution to economic problems, it must be enacted rather quickly. The American system of government was designed such that hasty action is difficult. Add to this the frequent situation in recent decades of divided government, and quick action becomes more difficult.

2. Monetarism

- A school of economic thinking known as monetarism undercut the Keynesian theoretical claim that fiscal policy could fine-tune the economy. The reasoning: if a government borrows money, it soaks up some of the country's savings and has fewer savings to finance investment, so economic growth slows.

3. Growing Budget Deficits

- Fiscal policy might have been effective in the 1960s, but that was because the deficit was not that large. The federal debt skyrocketed in the 1980s, partially due to supply-side economics ("Reaganomics"). It has also skyrocketed since 2001 (post 9/11) to fight the war on terrorism both at home and abroad; so much so that aggressive fiscal policies have become politically infeasible.

4. Internationalization

- A school of economic thinking called rational expectations developed in the 1970s that, when successful, counteracted any effect the government planned through fiscal policy.
- Also, as economic activity became increasingly international, the reactions of economic actors to government policies were no longer limited to reactions in their own countries. In other words, investors can vote with their money, thus imposing economic costs on the government that adopts unfavorable policies.

V. Monetary Policy: The Federal Reserve System

- Today, monetary policy is the government's most important tool for managing the economy. Basically, monetary policy relies on raising or lowering interest rates, which governments do by subtracting or adding money to the economy. More money means lower interest rates; less money means higher interest rates.

- An advantage monetary policy has over fiscal policy is that it can be altered quickly in response to changing economic conditions.
- Created in 1913, the Fed is responsible for managing the government's monetary policy. It acts on the economy through the operations of its 12 regional banks, each of which oversees member banks in its part of the country.
- The most important decisions affecting the economy on a daily basis are made by the Fed's Open Market Committee (OMC) consisting of the seven governors and 12 regional bank presidents, only five of whom have a vote.

  A. The Fed Chair

  - The person chairing the Fed is very powerful due to the close ties to the President, direct access to up-to-date economic information, and the power to approve the appointment of the 12 presidents of the Federal Reserve Banks.

  B. Who Controls the Fed?

  - The Fed is relatively insulated from electoral politics.

    1. Congressional Influence

    - Congress created the Fed; all nominees must be approved by the Senate, and the Fed must make quarterly reports to the banking committees of the House and the Senate.
    - Still, the Fed is insulated from congressional control due to its ability to literally create its own budget. It is also relatively free of congressionally determined salary schedules and personnel controls. The control Congress does exercise over the Fed is indirect: jawboning and public hearings.
    - If Congress does not exercise significant control over the Fed, who does? There are three distinct answers.

    2. Banker Dominance

    - One answer is that banks control the Fed.
    - This answer relies on evidence that indicates the Fed is mainly concerned with low inflation and preventing recession, the same concerns of banks. The Fed tries to defend itself against such claims by arguing it must take actions that may appear to favor banks or else the economy could be severely damaged.

    3. Presidential Dominance

    - While the President clearly can influence the Fed since he appoints its members and chairs, the question is: how much influence does he have?
    - Two versions of presidential control interpretation, the partisan and the election cycle, have been proposed.
    - The partisan control explanation goes like this: Republicans tend to favor tight monetary policy, while Democrats tend to favor loose monetary policy. The Fed strives to follow the approach of whoever is in power. However, this influence is too weak and indirect to call it presidential control.

- The election cycle interpretation goes like this: presidents deliberately manipulate the economy. They tolerate slow growth early in their terms and then rev up the economy as the election approaches to help guarantee their reelection. The problem with this interpretation is that the pattern it relies on is only slightly confirmed by historical fact.

4. An Independent Fed

- Fed supporters say several factors guarantee the independence of the Fed: 14-year terms for board members; removal only by impeachment; a strong, independent staff, a chair that is usually more knowledgeable about economic policy than any presidential appointee; and an independent Fed that is viewed by many as a good thing.

VI. The "T" Word: Taxes

- Taxes are a hot political issue since most Americans think taxes are too high and the government spends the money on frivolous programs.

A. The Tax Burden

- Taxes, as a percentage of the Gross National Product (GNP), scarcely increased between 1970 and 1990. While some people think Americans are getting stingy with paying taxes that could go to good causes, others think taxes are just too high, especially with wages not increasing much.
- In part because of the size of the budget surplus following economic growth in the 1990s, each presidential candidate in the 2000 campaign advocated some tax cuts.
- The 2004 presidential campaign actually had Democratic nominee John Kerry calling for a tax increase on the upper one-percent of Americans.

B. The Tax Base

- Economists argue that taxes are less intrusive if they tax all economic activity at the same rate. If everything is taxed alike, then tax policy will not distort the economy. But this is easier said than done since good reasons can often be given for not taxing some activities, and groups pressure Congress not to tax their favorite activities. Lawmakers have responded with thousands of tax preferences.
- The government also sometimes imposes "sin" taxes, taxes intended to discourage unwanted behavior. Examples would be taxes on cigarettes and alcoholic beverages.

C. Tax Progressivity

- Taxes are said to be progressive if people with higher income pay a higher tax rate, such as with the income tax.
- Taxes that require low-income people to pay a higher rate are called regressive, such as the payroll or Social Security tax.
- Conservatives generally dislike progressive taxes. Taxes vary so much in the United States that it is difficult to characterize the tax structure as progressive or regressive.

D. Tax Reform

- One reform mentioned in recent years is the flat tax. It would tax all income groups above a certain minimum at the same rate, eliminating the progressivity of the income tax. It is touted as fairer and less complex.
- A more radical proposal for tax reform is to change the basis of taxation to, say, a value-added tax, a consumption tax. Liberals oppose the idea because it is not progressive; conservatives oppose it because it is too easily hidden.
- The debate over tax reform is fractious because people want to use the tax system to achieve different goals that often conflict. One thing seems certain: Americans don't like the current tax system.

VII. The U.S. Economy: An International Comparison

- In today's worldwide economy, the U.S. economy is often subject to forces beyond the control of America's politicians. Relative to other advanced democracies, the United States is dealing reasonably well with its economic challenges and difficulties.

A. Taxes

- As of 1998, the tax burden in the United States was among the lowest of 13 major industrialized countries, at about 34 percent of the GDP. However, other countries provide more services in exchange for the money extracted in taxes, like health care. Why, then, are Americans so unhappy with their taxes?
- Part of the answer may be due to the fact that so much of the tax money raised in the U.S. comes from payroll taxes. Nearly two-thirds of the tax money is raised this way. In addition, Americans are economic individualists who wish to keep the role of government limited.

B. National Debt

- As of April 2011, the national debt is a whopping $14.3 trillion.
- The estimated population of the United States is 311,000,000, so each citizen's share of this debt is $45,933 or $128,552 per taxpayer. The National Debt has continued to increase an average of almost $2 billion per day since September 30, 2003.

C. Employment Opportunities

- The United States has done a better job than most countries of incorporating new workers into the economy. The United States did a better job of absorbing the baby-boomers into the economy in the 1980s than Western Europe.
- While some say the jobs created in the United States were low-skill, low-paying service-based "McJobs", the evidence suggests otherwise.
- Compared to most other countries, the American economy is less restricted by government policies and regulations.

D. Inequality

- Compared to other advanced democracies, income inequality in the United States is higher. While some criticize this situation, there seems to be no popular demand for government to do anything about it, and candidates advocating such a governmental role usually lose.